UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re Case No. 94-57475-JRG

NICK HOLQUIN, JR. and JUANITA C. HOLQUIN,

Debtors.

_____/

JAMES MURDOCK and REGINA MURDOCK, Adversary No. 98-5297

Plaintiffs,

vs.

NICK HOLQUIN, JR. and JUANITA C. HOLQUIN,

Defendants.

_____/

MEMORANDUM DECISION

I. INTRODUCTION

The issue before the court is the dischargeability of a $350,000 claim held by James and Regina Murdock. The claim was created in connection with a chapter 11 plan of reorganization confirmed in the case of Nick and Juanita Holquin. Subsequent to

confirmation there was a material default under the terms of the plan. Pursuant to § 1112(b)(8) of the Bankruptcy Code[1] the case was converted to one under chapter 7. For the reasons hereafter stated the court concludes the Murdocks claim was discharged in the chapter 7 case.

II. FACTUAL BACKGROUND

In November 1994, involuntary petitions for relief under chapter 7 of the Bankruptcy Code were filed against Nick and Juanita Holquin. The cases were later converted to chapter 11 and an order for relief was entered in February 1995.

Prior to bankruptcy, the Murdocks utilized the tax preparation services of Nick Holquin for a number of years. During the course of this relationship there were other business transactions between the parties resulting in the Murdocks holding a number of pre-petition claims against the Holquins. In the course of the case a chapter 11 Trustee was appointed who subsequently assisted in the formulation of a reorganization plan.

On March 13, 1996, Nick Holquin and James Murdock entered into an Agreement of Understanding regarding the Holquins' reorganization. Under the Agreement, the Murdocks agreed to deposit $350,000 with the chapter 11 Trustee to fund the Holquins' plan of reorganization. This amount was to constitute an unsecured loan that the Holquins would repay by securing an additional loan on certain real property the Holquins owned located in Laytonville, California.

The plan of reorganization was confirmed on October 9, 1996.

[1] All references to code sections are to the Bankruptcy Code unless otherwise noted.

The plan was funded by the $350,000 Murdock loan. In addition the plan, as amended in the order of confirmation, provided:

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> 2.1 James R. Murdock has deposited with the Trustee and the Trustee is holding in trust, pending Confirmation of this Plan, the sum of $350,000, plus some nominal interest thereon (collectively, the "Fund"). The Fund shall be held in an interest bearing account pending distribution to creditors. The Fund shall be used to make all payments required under this Plan except for payments on the Laytonville Junior Lienholder Claims to be paid under promissory notes secured by a lien on the Laytonville Property.
>
> ....
>
> 2.3 Debtors are to repay James R. Murdock and the Laytonville Junior Lienholders' notes from operation of the Laytonville Property, sale or refinancing of the Laytonville Property or any other method Debtors chose.

The Holquins subsequently defaulted on the confirmed plan. On April 27, 1998, this court granted the Murdocks' motion to convert the case to chapter 7. The Murdocks then filed proofs of claim in the chapter 7 case, which included one for $350,000. The Laytonville property was administered in the chapter 7 case and the trustee was ultimately able to sell it. There were a variety of disputes over the Murdocks' claims which were finally settled by the trustee providing the Murdocks with a possible dividend in the case.

While the Murdocks were successful in having the case converted to chapter 7, there was a second action taken by them. The statement of undisputed events set forth in the Joint Pretrial Submissions states that on "January 6, 1998, the Murdocks' filed a state lawsuit in the Superior Court in San Jose against the Holquins for breach of contract, among other things." There is no

indication about whether this suit related to the $350,000 loan. At the end of July 1998, the Murdocks obtained and recorded a prejudgment writ of attachment in the amount of $400,000 against the Holquins' property located at 625 North First Street. This property was also scheduled in the chapter 11 case and included in the plan of reorganization. This court issued a permanent injunction against enforcement of the state court proceedings and writ based on the conclusion that the Murdocks' claims were subject to discharge.

This case proceeded to trial on the dischargeability of the claims held by the Murdocks. During the course of trial the parties reached a settlement by which they agreed that the status of the $350,000 claim would be submitted to the court for decision based on the evidence provided.[2]

III. THE MURDOCKS' ARGUMENT

The Murdocks' now appear to argue that their $350,000 claim is not subject to discharge in the converted chapter 7 case because they are pursuing state law remedies and have obtained a prejudgment writ of attachment against the Holquins' property at 625 North First Street. At the same time the Murdocks assert:

> [The] claim is post-confirmation and not subject to [the] converted Chapter 7 case. Having exercised jurisdiction over [the] claim, [the] court should respect state court lien priority, allow [the] claim to be brought to general judgment, allow for execution of federal judgment, and substitute federal lien nunc-pro-tunc in place of [the] state lien, with [the] same rights and priority. National City Bank v. Troutman Enterprises, Inc., 253 B.R. 8, 12-13 (6th Cir. BAP 2000); see also In re Canal St. Ltd Partnership, 260 B.R. 460,

[2] In order to deal with this issue completely, the Court took judicial notice of documents in the record, such as the plan, the order for confirmation, and the trustee's final report, which were not presented as evidence at trial.

462 (Bankr. D. Minn. 2001), citing In re Ernst, 45 B.R. 700, 702-03 (Bankr. D. Minn. 1985).

At the conclusion of the trial, the Murdocks urged the court to consider In re Troutman Enterprises, Inc., 253 B.R. 8 (B.A.P. 6th Cir. 2000), as controlling the nature of their rights with respect to their $350,000 claim. The court interprets the Murdocks' argument to be that under Troutman, they are entitled to pursue remedies in state court, even after the case has been converted to a chapter 7, because § 348 of the Code did not eliminate those remedies. Thus, contract principles allow them to pursue their claim against the reorganized debtor.

IV. DISCUSSION

Section 1141(d)(1) and (2) of the Code operate to discharge all claims that arose before the date of confirmation except any claims excepted from discharge under § 523. As such, the Murdocks' pre-petition claims were discharged at the time of confirmation. They are left with the $350,000 claim created in connection with the reorganization plan. There is no evidence that would except it from discharge under § 523. This leaves only the argument that it is simply not subject to discharge in the converted chapter 7.

A chapter 11 plan of reorganization constitutes a new contract between a debtor and its creditors. The treatment afforded each creditor in the plan gives that creditor a new claim under the plan or a "plan claim." In re Benjamin Coal Co., 978 F.2d 823, 827 (3d Cir. 1992)("[O]nce the reorganization plan is approved by the bankruptcy court, each claimant gets a 'new' claim, based upon whatever treatment is accorded to it in the plan itself.").

In this chapter 11 case the Murdocks' $350,000 claim was a

plan claim. The Agreement of Understanding was entered into in March 1996, prior to confirmation. As stated in this court's Order Denying Motion for Summary Judgment:

> [W]hen the Trustee disbursed the Murdocks' $350,000 pursuant to the terms of the plan, the Murdocks obtained a new post-confirmation claim against the Holquins as reorganized debtors. Pursuant to the Plan, the Holquins had an obligation to repay the Murdocks from operation, sale, or refinance of the certain real property in Laytonville, California, or by 'any other method' the Holquins chose.

Confirmation of the plan discharged the claim under the Agreement of Understanding and replaced it with the Murdocks' plan claim under paragraph 2.3 of the plan.

While it would be nice to think that all confirmed plans are successfully completed, such is not the case. In some cases the reorganized debtor defaults under the terms of the plan. When a default occurs creditors have several options available to them to pursue recovery. These include initiating an action in state court and enforcing rights in collateral. See, e.g., In re Xofox Indus. Ltd., 241 B.R. 541, 544 (Bankr. E.D. Mich. 1999).

Remedies are also created by the Bankruptcy Code. With respect to confirmed plans, § 1112(b)(7), (8) and (9) set forth circumstances that serve as cause for converting a chapter 11 case to one under chapter 7. One such circumstance is where there has been a "material default by the debtor with respect to a confirmed plan." Bankruptcy Code § 1112(b)(8). This is precisely what occurred in this case.

Following conversion, the debtor has certain duties. Bankruptcy Rule 1019(5)(C) provides that after conversion the debtor shall file:

> (i) a schedule of property not listed in the final report and account acquired after the filing of the petition but before conversion, except if the case is converted from chapter 13 to chapter 7 and § 348(f)(2) does not apply;
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> (ii) a schedule of unpaid debts not listed in the final report and account incurred after confirmation but before the conversion; and
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> (iii) a schedule of executory contracts and unexpired leases entered into or assumed after the filing of the petition but before conversion.

Thus it appears that there is to be a full accounting for the assets and liabilities of the reorganized debtor.

Section 348 of the Code sets forth some of the effects of conversion. For example, it controls the characterization of creditor claims following conversion. Section 348(d) provides:

> (d) A claim against the estate *or the debtor* that arises after the order for relief but before conversion in a case that is converted under section 1112 ..., other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition. [Emphasis added.]

Since the statute refers to claims existing at the time of conversion it seems clear that it covers "plan claims" created at confirmation as well as claims incurred in the ordinary course of business following confirmation. Since all of the existing claims at confirmation are now in the chapter 7 case it also seems clear that they will be discharged unless there is a basis under § 523 to except them from discharge. In re Pavlovich, 952 F.2d 114, 118-19 (5th Cir. 1992). The remedy provided by § 1112(b) provides that the "court may convert a case under this chapter to a case under chapter 7 of this title ...." The statutory language appears clear. At this juncture one could conclude that a normal chapter

7 case is being created that will liquidate all the assets to satisfy creditor claims to the extent possible.

While § 348 sets forth some of the effects of conversion, it does not specifically indicate what happens to the assets of the reorganized debtor. As a result, a few courts have concluded that the chapter 7 created by conversion differs from the normal chapter 7 in that it does not contain all of the assets of the debtor. The property of the estate that vests in the debtor upon confirmation under § 1141(b) does not revest in the estate when the case is converted. In re T.S.P. Indus., Inc., 117 B.R. 375, 377-79 (Bankr. N.D. Ill. 1990).

The Troutman case, relied on by the Murdocks, ultimately comes to this conclusion. Troutman involved a conversion to chapter 7 after the debtor defaulted on its confirmed chapter 11 plan. The conversion was initiated by one creditor, the Internal Revenue Service. Four other plan creditors later filed an involuntary chapter 7 petition against the same debtor. The bankruptcy court found that once the case was converted § 348(d) gave the four petitioning creditors pre-petition claims in the converted case subject to discharge. As such they held no enforceable claims against the reorganized debtor. The bankruptcy court then dismissed the involuntary petition.

On review, the Sixth Circuit Bankruptcy Appellate Panel (BAP) reversed. The BAP stated that:

> If a reorganized debtor defaults under a plan, creditors have several options, including enforcing the plan terms in any court of competent jurisdiction. In re Xofox, Indus. Ltd., 241 B.R. at 543. A creditor may also look to the Bankruptcy Code, with the nature of the available relief depending on the facts of the case. Potential remedies include

> the dismissal or conversion of the confirmed case in the event of (1) inability to effect substantial consummation of a plan; (2) material default with respect to a plan; or (3) the termination of a plan pursuant to a condition provided for in it. 11 U.S.C. § 1112(b)(7), (8), and (9). The bankruptcy court may also order the debtor to take actions necessary to transfer property and perform other acts to carry out the plan. 11 U.S.C. § 1142(b).

In re Troutman Enter., Inc., 253 B.R. at 11.

The BAP in Troutman then concluded that the estate property, revested in the reorganized debtor at confirmation, remained property of that entity, and conversion did not bring that property into the converted case. Id. at 13. Thus the reorganized debtor continued its separate existence as a legal entity with whatever assets it owned, including the assets that revested on confirmation of the chapter 11 plan. Id.

This conclusion raises a potential consequence that could not have been intended by Congress. Since all of the claims are now in the converted chapter 7 case and subject to being discharged, the defaulting debtor would be able to continue in business with all the assets but free of all the liabilities. To avoid this result the Troutman court creates a distinction between the discharge of claims in the chapter 7 case and the debtor's contractual liability to creditors on the "plan claims." The court holds that contractual liability continues to exist despite the discharge of all claims in the converted chapter 7 case. Exactly what was discharged in the chapter 7 case is not clear.[3] Having

[3] The effect of a discharge is set forth in § 524 of the Code. As a general proposition, creditor claims become unenforceable against the debtor when discharged. If the plan claims are contractually enforceable they are not discharged as described in § 524. There also is the question of the status of creditor claims incurred in the ordinary course of business following confirmation. These are not plan claims. If these claims are discharged then these creditors are discriminated against in favor those holding plan claims. There is no apparent basis for such discrimination. If, on the other hand, these claims also are not

created this distinction, the BAP concluded the four creditors filing the involuntary petition against the reorganized debtor held contractual claims sufficient to support the involuntary petition. Id.

Courts in the Ninth Circuit have rejected the T.S.P. and Troutman approach with respect to the converted chapter 7 estate. In In re Smith, 201 B.R. 267 (D. Nev. 1996), *aff'd,* 141 F.3d 1179 (9th Cir. 1998), the court considered the question one of statutory interpretation. The court started with the premise that "Courts must presume that Congress 'says in a statute what it means and means in a statute what it says ....'" Id. at 272 (quoting Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992)). The court concluded T.S.P.'s approach would render § 1112(b)(7-9) of the Code meaningless and such an interpretation could not be supported absent a finding of Congressional intent. Id. at 273. In essence, a case converted to chapter 7 after confirmation should be no different than one converted prior to confirmation. Id. at 274 (discussing In re Calania Corp., 188 B.R. 41 (Bankr. M.D. Fla.1995)).

The Ninth Circuit Court of Appeals has also rejected the argument that no estate exists for conversion to chapter 7. In re Consolidated Pioneer Mortgage Entities, 264 F.3d 803 (9th Cir. 2001). The court looked to the purpose of a plan which provided for the liquidation of assets for the benefit of creditors. When this was not accomplished by the reorganized debtor the court found

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discharged, the result seems to be a chapter 7 case with little or no assets and no discharged claims. Such a result would conflict with the Fifth Circuit's clear ruling in Pavlovich.

that the assets were being held for the benefit of creditors and therefore became assets of the estate in the converted chapter 7.

This case is similar in that the Murdocks' claim was tied to the Laytonville property. The argument for an estate in the converted chapter 7 is even stronger as the Laytonville and other property was administered by the trustee in the chapter 7 case. Thus, the parties to this converted bankruptcy recognized the existence of an estate with assets administered by the chapter 7 trustee.[4]

Smith and Consolidated Pioneer are persuasive as already noted by one court in this district. See In re RJW Lumber Company, 262 B.R. 91, 93 (Bankr. N.D. Cal. 2001). There is no basis to ignore the express language in § 1112(b) and no indication Congress had some intention it failed to express. For the reasons discussed above, the court concludes the reasoning of Troutman is not controlling. In the Holquins' converted chapter 7 an estate existed and at the time the Murdocks became a creditor in the

[4] A review of case law demonstrates that not all courts agree with the analysis of T.S.P. and Troutman. In In re Midway, Inc., 166 B.R. 585, 590 (Bankr. D.N.J. 1994), the court rejected the T.S.P. approach stating that it ignored the provisions of chapter 7 relating to the distribution of estate property. The court relied on cases that presumed the assets to be part of the chapter 7 estate and those that found the date of conversion to be the logical date to determine property of the estate. Id. at 590 (discussing In re Pauling Auto Supply, Inc., 158 B.R. 789 (Bankr. N.D. Iowa 1993); In re Lindberg, 735 F.2d 1087 (8th Cir. 1984)(chapter 13 case prior to addition of Bankruptcy Code § 348(f)); In re Wanderlich, 36 B.R. 710 (Bankr. W.D.N.Y. 1984) (chapter 13 case prior to addition of Bankruptcy Code § 348(f))).

Persuasive is the conclusion in both Midway and Pauling Auto Supply that a converted chapter 7 estate exists because assets were turned over to the chapter 7 trustee on the presumption that the assets were estate property. This too appears to have happened in this case because the chapter 7 trustee has administered assets as part of the chapter 7 estate.

converted case their $350,000 claim was subject to discharge.[5]

V. CONCLUSION

For the reasons stated above, the court does not find Troutman persuasive. Here the Murdocks elected as their remedy to pursue a chapter 7 conversion and assert their $350,000 claim therein. A chapter 7 estate existed and was administered by the trustee. The Murdocks are limited to the distribution received as a creditor in the converted chapter 7. It would be contrary to the purpose and policy of bankruptcy law to allow a creditor in the converted case to continue to pursue state law remedies against the debtor. Because the Murdocks conceded at trial that they have no evidence to challenge the dischargeability of the claim under § 523, their claim is discharged in the converted chapter 7 case.

The forgoing constitutes the court's findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.

DATED:_____

_____
JAMES R. GRUBE
UNITED STATES BANKRUPTCY JUDGE

[5] The court also notes that, unlike the four petitioning creditors in Troutman, the Murdocks were the driving force behind the conversion. They petitioned the court to convert the case and proceeded to file proofs of claim in the converted chapter 7. The Murdocks made a choice to pursue conversion and recovery of their plan claim within the chapter 7. They now essentially argue that the conversion of a chapter 11 case post-confirmation creates a unique chapter 7 in that they are allowed to pursue their plan claim both inside and outside the bankruptcy. Such an argument is absurd given their clear choice to pursue their claim by way of conversion to chapter 7 and the policy and purpose underlying bankruptcy.

Adversary No. 98-5297

UNITED STATES BANKRUPTCY COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

CERTIFICATE OF SERVICE

I, the undersigned, a regularly appointed and qualified Judicial Assistant in the office of the Bankruptcy Judges of the United States Bankruptcy Court for the Northern District of California, San Jose, California hereby certify:

That I, in the performance of my duties as such Judicial Assistant, served a copy of the Court's **MEMORANDUM DECISION** by placing a copy in the United States Mail, First Class, postage prepaid, at San Jose, California on the date shown below, in a sealed envelope addressed as listed below.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on _____ at San Jose, California.

_____
LISA OLSEN

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